Briefing Memo

The Relationship between the Financial Crisis and Security/Military Issues

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The financial crisis that broke out in the United States in 2007 spread instantly across the world. Though there was concern initially over the potential impact of the crisis on security, the United States and other industrial nations currently are beginning to witness signs of an economic recovery. That was not necessarily the case with past financial crises, however. Traditionally, the primary financial problem that concerns security is inflation, and in case of a large-scale war, inflation emerges frequently in both defeated and victorious countries as they raise expenses of war by issuing increased amounts of currency. The hyperinflation in Germany after World War I and inflation in Japan after the end of World War II are typical examples. In Medieval Europe as well, the usual practice of raising expenses of war was the reminting (degradation of quality) of coins, which led to inflation and caused economic disruptions as well as long-term declines in revenue. At present, however, the relationship between financial crises and security problems has become more complex. This article attempts to study the causal relationship between the two.

Causal Relationship between Financial Crises and Security/Military Issues in the Past

(1) Causes for Financial Crises

In the Nixon Shock of 1971, the concomitance of the budget deficit stemming chiefly from spending on the Vietnam War and the trade deficit due to the booming economy triggered the decision by the administration of President Richard Nixon to abandon the Bretton Woods regime built around the fixed exchange rate system. The debt crisis in Latin America in the 1980s occurred as a result of oil money amassed by oil-producing countries in the Middle East through the first and second oil crises flowing mainly into Latin American countries, then thought to have high growth potential, via private-sector banks in industrial nations in pursuit of profitable investment opportunities. Thus, the Nixon Shock and the Latin American debt crisis were directly or indirectly caused by the Vietnam War, and the Middle East war (the first oil crisis) and the Iranian Revolution (the second oil crisis), respectively. They are examples of where security and military problems have caused increases in excess liquidity.

At the same time, in the case of the Latin American debt crisis, the unstable situation of Latin America led to increased defense spending and larger imports of weapons in many countries under the military dictatorship, which resulted in the deterioration of the debt problems. Further, a rapid outflow of short-term investment funds witnessed in the Mexican peso crisis of 1994 was in part traced to the fact that an armed uprising by the Zapatista National Liberation Army spawned concerns among foreign investors (subsequently, there was a series of assassinations of influential politicians). As exemplified by this, there were cases where security and military problems triggered an outflow of exchange reserves and exacerbated financial crises.

(2) What has Resulted and and what was Feared to Result from Financial Crises

As the process of a financial crisis weighing on security and military issues, there are broadly two types of responses: the first is measures to deal with liquidity (foreign exchange reserves) in order to remove the cause of the financial crisis, and the second is measures to cope with regional instability caused by the financial crisis through economic recession. In the former case, Indonesia, Malaysia and the Philippines temporarily suspended or postponed imports of weapons and cut back on national defense budgets amid the Asian currency crisis of 1997. Particularly in Thailand, the Royal Thai Navy's *Chakri Naruebet*, the first light aircraft carrier to be deployed in Southeast Asia, remained in a state of poor operations for some time because of the shortage of funding due to the currency crisis.

Causal Relationships between Major Postwar Financial Crises and Security/Military Issues

Occurrence time	Name of the financial crisis	Causal link with security/military issues
1971	Nixon Shock	A: the Vietnam War
1980s	Latin American Debt Crisis	A: the Fourth Middle East War; the Iranian Revolution; increased defense spending and weapons imports B: Instability of the regional political situation; the Falkland Islands War
1992	Pound Crisis	(Links with security/military issues were not observed)
1994	Mexican Peso Crisis	A: Political unrest triggered by armed insurgents
1997	Asian Currency Crisis	B: Political instability; emergence of refugees; cutbacks on defense spending and weapons imports; an impact on the presence of U.S. forces
2007	Global Financial Crisis of 2007	A: 9/11 multiple terrorist attacks; the Iraq War B: Reduced support for developing countries and refugees as well as political instability

A: What caused the financial crisis
B: What resulted or was feared to result from the financial crisis

The Falkland Islands War of 1982 can be cited as an example of the latter case. Argentina, under the government of President Gen. Leopoldo Fortunato Galtieri, sent army troops to land on and take control of the Falkland Islands on April 2, 1982. The Falkland Islands War is said to have been in part an attempt by the military government of President Galtieri to divert mounting public discontent with economic disruptions caused by debts accumulated by the country. In the Asian currency crisis, meanwhile, there were concerns over the deterioration in the security situation following the inflows of Indonesian refugees into Malaysia and Singapore in the wake of the recession in Indonesia. Further, as the financial crisis might reduce the operational capabilities of the navies of Southeast Asian countries and the economic disruptions also lowered these countries' abilities to resupply and support U.S. naval vessels calling at Southeast Asian ports, there arose apprehensions about the security of sea lanes in ocean areas of the region as well as over the possible impact on the presence of the U.S. forces, which are expected to play a major role in maintaining regional stability.

The Global Financial Crisis of 2007 and Security/Military Issues

The global financial crisis of 2007 is reviewed below from the perspective of the causal relationship between financial crises and security/military issues. In terms of increased liquidity, the causa remota of the latest financial crisis that started in the United States can be traced to the series of terrorist attacks in the United States and the subsequent Iraq War. As the primary targets of the simultaneous terrorist attacks in the United States on September 11, 2001, were the World Trade Center, which housed many financial institutions, settlements of financial transactions became impossible immediately after the terrorist attacks, throwing the financial markets into chaos. Consequently, the New York Stock Exchange was forced to shut down temporarily, and the Federal Reserve Board (FRB) made a complete about-face in monetary policy, shifting from tight credit to all-out credit easing. While the FRB's policy stance at the time was fully endorsed, it provided a hotbed for the real estate bubble touched off by the ensuing excess liquidity. Then, the Iraq War, launched in March 2003, made crude oil exports from Iraq, with the world's second largest oil reserves, impossible, sending crude oil prices soaring and bringing huge trade surpluses to oil-exporting countries. In addition, emerging market economies, led by China, amassed foreign exchange reserves in tandem with their economic development. As these countries chose the United States as a place to invest their surplus funds, liquid funds that poured into the United States also flowed into the real estate market to reinforce the asset-inflated bubble economy.

In 2006, however, the rise in U.S. house prices slowed down. In particular, as people who took out subprime loans, mortgage loans principally for individuals with relatively low credit standings, planned their repayments on the assumption of the continuous increase in house prices, the decline in house prices resulted in arrears in repayments by these borrowers, some housing-loan companies with cash-flow problems began going under. Furthermore, as subprime loans were securitized and incorporated into financial instruments that financial institutions around the world were selling, the credit uncertainty rapidly spread to the entire world. In 2008, serious troubles at Bear Stearns, a major investment bank, were revealed, and then in September 2008, another major investment bank, Lehman Brothers, fell into bankruptcy, spawning the credit contraction around the world and the financial crisis came to the fore with the United States as it epicenter.

Prof. Paul Rogers of the University of Bradford observes that while the latest U.S.-originated financial crisis is different from the past financial crises in nature, if a comparison has to be made, it resembles the state of affairs after the first oil crisis touched off by the Fourth Middle East War of 1973, rather than the Asian currency crisis of 1997. Prof. Rogers cited the following three reasons for his observations: (1) though it was the U.S.-originated financial crisis, its ripple effects spread to cover the entire world instantaneously; (2) the real economy was affected by the dwindling of investment funds that reflected liquidity and credit concerns about the financial sector; and (3) it is expected to take at least two years to bring the financial crisis to an end and a few months longer to realize an economic recovery. It was also feared that the financial crisis would help widen the gap between the rich and the poor and further fuel ongoing civil war and insurgency as well as political instability. The third reason cited by the professor points to the impact of the financial crisis on security and military issues. Furthermore, as the latest financial crisis originated in the United States and had no small impact on Japan and European countries, major industrial countries and international financial institutions to which industrial countries provide capital were both forced to cut back on development assistance, raising concerns over possible fallout on the political unrest in developing countries as well as on support for refugees. In particular, the sharp increase of food prices that roughly coincided with the financial crisis significantly hampered refugee assistance projects of the U.N. World Food Programme (WFP).

Efforts in Recent Years and Remaining Problems

The Mexican peso crisis of 1994 was settled with agreement on a framework of international financial support forged in about a half year since the breakout of the crisis. In the Asian currency crisis as well, a conference of donor nations was convened in Tokyo in the following month of the emergence of the crisis and support measures by Japan and other industrial countries as well as by international institutions were put together swiftly. The financial unrest itself was brought under control in about a year, though there was a change of government in Indonesia, and South Korea and Thailand suffered from serious recessions. Also in the latest financial crisis, industrial nations are beginning to see signs of their economies bottoming out less than a year after the failure of Lehman Brothers.

As seen above, stronger cooperation among financial authorities of mainly industrial nations in providing liquidity and foreign currencies is the principal factor helping recent economies climb out of the worst periods of financial crises within about a year. For example, the ASEAN (Association of Southeast Asian Nations) Plus Three Finance Ministers' Meeting held in Chiang Mai, Thailand, in May 2000 agreed on the building of a network of bilateral currency swap arrangements. The currency swap arrangements in effect involve $64.0 billion, of which Japan is involved in $44.0 billion. The overall size of the present arrangements substantially exceeds the New Miyazawa Initiative for a package of financial support measures worth $30.0 billion announced at the joint annual meeting of the International Monetary Fund (IMF) and the World Bank held in October 1998 in the wake of the Asian currency crisis. Also in case of a financial crisis entailing liquidity problems, if an advanced industrial nation is involved in the occurrence of the crisis, the risk of the financial crisis becoming protracted can be described as small, since the industrial nation itself, in most cases, is capable of dealing with the crisis. These situations, needless to say, can contain the aggravation of the financial crisis and also has the effect of forestalling the spread of the financial crisis to security and military issues.

When an international framework of responses to liquidity crises is being put into place, it would be reasonable to say that the possibility of a financial crisis developing into a major seismic tremor has been significantly reduced in comparison with past experiences. Thus, even when liquidity crises arise with security and military problems acting as the trigger, they are highly likely to be contained at a certain stage. Furthermore, the risk of security-related issues being raised as a consequence of financial crises is becoming smaller as well. If we venture to point out the remaining problem, it is the presence of China, which has come to the forefront on the international financial market as well. The internationalization of the renminbi, or the Chinese yuan, has been making steady progress, and capital transactions in China are likely to be liberalized fairly rapidly. In reality, however, China's financial system remains underdeveloped, and the Chinese market is likely to fall prey to international speculators if liberalization of capital transactions goes ahead at a rapid pace with the current financial system remaining intact. In that event, the Chinese yuan could fluctuate wildly and give rise to a global financial crisis originating in China. Since the Chinese economy is not yet as resistant as the economies of industrial countries, the chaos may not be brought under control so easily and could go on for a long period of time even if international cooperation is invoked to prevent the broadening of the financial crisis. In that event, the possibility cannot be ruled out of security issues (such as the incidence of refugees and regional destabilization) arising from the China-originated financial crisis taking a long time to get settled.

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The purpose of this column is to respond to readers' interests in security issues and at the same time to promote a greater understanding of NIDS. A "briefing" provides, among other things, background information. We hope these columns will help everyone to better understand the complex issues involved in security affairs. Please note that the views in this column do not represent the official opinion of NIDS. Please contact us regarding any questions, comments or requests you may have.

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